A Response

to the Minister's Discussion Paper

on

Public Sector Pensions

Universities Academic Pension Plan

Alberta

Universities Academic Pension Plan Board

September 30, 1991

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Alberta
GOVERNMENT PENSION BOARDS

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September 30, 1991

The Honourable Dick Johnston
Provincial Treasurer &
Minister Responsible for
Public Sector Pensions
224 Legislature Building
EDMONTON, Alberta
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Sir:

Subject: Initial Response to the Proposed Plan Changes

On behalf of the Universities Academic Pension Plan Board, I have the honour to submit our initial response to your July 9, 1991 proposal "Planning Responsibly for the Future - A Discussion Paper on Public Sector Pensions" in respect of the Universities Academic Pension Plan.

Yours truly,

J. E. Faries, FCIS
Chairman

Encl.

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PREFACE

On July 9, 1991 the Minister responsible for public sector pensions released a discussion paper that outlined a number of proposed changes to the Universities Academic Pension Plan (UAPP). The Minister asked the UAPP Board, which is composed of employee, employer and government representatives, to respond to the proposal by the end of September. This response should be considered an initial response by the Board because:

1) A number of technical issues, especially those related to the application of Federal income tax limits, need to be clarified both in terms of the government's intent and alternatives that may be considered.

2) Many of the Board's recommendations are contingent on further discussions with the Minister on specific issues such as governance. This report is a first step in beginning the dialogue necessary to achieve a solution that is acceptable to all parties to the "pension deal".

3) Lack of sufficient information. Treasury was able to provide adequate information to assess the specific proposal but there was not enough information to assess alternatives. For example, the Board did not receive a preliminary separate accounting of the pension fund's assets until the last week in September.

4) Inadequate time to consult the stakeholders.

The response reflects participation by employee and employer representatives in addressing common concerns. This report represents the views of Board members as advisors to the Minister and not necessarily the positions of the employees and employers they represent.

The Minister's proposal has three expressed goals:

1) Secure the financial base,

2) Improve portability of future service benefits,

3) Meet the new Federal income tax rules.

To secure the financial base of the plan, the Minister's proposal notes that "true pension security for employees requires that all benefits be fully funded and backed by marketable assets." To achieve this goal the Minister recommends that:

1) The indexing of pensions be formally recognized at 60% of inflation for both past and future service.

2) The cost of liquidating the past service unfunded liability of the five plans be equally shared by all employees, employers and the government.

3) Future service be paid, as it accrues, by employers and employees by requiring that contribution rates be adjusted periodically to reflect the "annual pension cost"[1].

To achieve the remaining two goals the Minister proposed to change a number of plan provisions and benefits. Per the proposal, the ability to purchase prior service will be eliminated, reciprocal transfer agreements cancelled, the rule of "80" will be introduced with early retirement factors set at 5%, the termination benefit will be based on the "50% rule" for service after 1992, and market rate of interest will apply on contributions after 1992. As well the plan will comply with the Federal contribution and accrual rules.

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1 "Annual pension cost" means the cost required to fund current service benefits and the increase or reduction to contributions to amortize a deficiency or surplus over specified period of time (eg. 15 years).

Compliance with the Federal tax rules is important to ensure that required employee contributions remain tax deductible. Another process has been put in place, whereby the plan will be brought on side through regulation. The Board has been assured that only the minimum changes necessary for compliance will be made and the Board will be able to review the changes prior to their submission to Cabinet.

It should be noted that the Federal Income Tax rules set the minimums for registration, and that considerable latitude exists in the choice of changes by which the UAPP could foreseeably be brought into compliance. The Minister's proposals lack information on the specific changes which would be implemented, and the Board wishes to highlight the importance of these issues to the costs and benefit structure of the plan.

The changes to the funding, benefit and administrative provisions of the plan are substantial. The Minister's proposal represents a fundamental change to the pension deal. No longer will the pension promise be secured by the Government's guarantee but by the imposed discipline of self-funding by employers and employees. Many of the unique features of the UAPP will also disappear.

Not surprisingly, the focal point of the Board's response is governance. Without addressing the governance context of the plan, contribution rates, the unfunded liability, indexing and other benefit changes cannot be adequately addressed.

This report has been submitted as a first step in developing the dialogue necessary to come to a solution that is satisfactory to all parties. We do not, however, see ourselves as the appropriate representatives of employees and employers because we lack a mandate to negotiate or agree to fundamental changes to the pension deal. The Board will continue to advise the Minister in seeking solutions that meet his and all participants' objectives.

MEMBERS OF THE
UNIVERSITIES ACADEMIC PENSION PLAN BOARD

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Chairman

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Government Representative & Vice Chairman

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EXECUTIVE SUMMARY

This report reviews the Minister's proposal not only on its own merits but also within the context of the plan's history. Each of the public sector plans has its own unique history. The original "pension deal" that was negotiated was a provincially sponsored and guaranteed defined benefit plan. The Minister's proposal would see the pension deal changed to a fully self-funded plan with the funding risk shared by employees and employers.

The common thread that binds this response together is governance. The issue of governance emerges not out of a desire to gain "control" of the pension plan by any party but rather out of a realization that the pension deal that was originally agreed to and implemented is no longer considered desirable by government. Unless the governance consequences of the "new pension deal" are properly addressed, it would be wrong to impose the discipline of full self-funding on employees and employers.

The Board has responded to many of the specific proposals regarding current service costs, indexing, the unfunded liability and other benefits. However, many of those responses are <u>contingent</u> upon the resolution of the governance issue.

The recommendations in this report are:

Governance:

1.1 A board of trustees (Trustees) be established consisting of employee, employer and government representatives.

1.2 The fiscal responsibility entailed in the sponsorship and administration of the plan be transferred by the Province to the Trustees.

1.3 The day-to-day administration of the plan be removed from the direct control of a government department and be operated as an independent agency accountable to the Trustees.

Unfunded Liability:

2.1 A separate accounting of assets and liabilities of the UAPP be provided from the inception of the plan in 1978.

2.2 The Province take responsibility for the unfunded liability attributable to the UAPP.

2.3 *Employees and employers should be asked to share in funding the past service unfunded liability if governance is changed so that to the extent possible the same level of benefits can be maintained for past and future service.*

Indexing:

3.1 *Adjustment to pensions in payment be based on a formula instead of the ad hoc system being currently applied by the Cabinet when adjusting pensions.*

3.2 *The indexing formula be based on a formula reflecting the rise in the Alberta Consumer Price Index minus a percentage.*

3.3 *The decision on the level of indexing be made by stakeholders taking into consideration the ability of the plan to fully fund the desired level.*

Current Service Cost:

4.1 *Combined employee and employer contributions be set equal to the annual cost of the pension plan with current service costs based on the unit credit method, with no additional funding cushion being applied.*

4.2 *Current service contributions be maintained at a rate sufficient to meet the current service cost of the plan, as certified by a qualified actuary.*

HISTORY OF THE PLAN

The UAPP came into existence in 1978, replacing the University of Alberta Pension Plan and the University of Lethbridge plan in order to provide uniform benefits for academic staff in the province's universities.

The plan's design and creation were the product of long and protracted negotiations. The resulting "pension deal"[2] can be best summarized by Mr. M. Leitch's (the then Treasurer and Minister responsible for provincially sponsored pension plans) introduction of The Universities Academic Pension Act second reading on May 9, 1978:

> *Essentially the staff and boards of universities will contribute to the cost of the pensions by contributing 13 per cent of payroll: 7 per cent by the employer and 6 per cent by the employee. I'm advised by our actuaries that would result in a positive cash flow for a period of 30 years into the future.*
>
> *The province will provide the administration of the plan and is bearing that cost. As part of the proposed plan, the province will take over pension funds that are now in academic pension plans and of course will assume the obligation to pay pensions as they are set out in the legislation. [Alberta Hansard, May 9, 1978]*

The key components of the pension deal included:

1) Government sponsorship of the defined benefit pension plan. The plan sponsor has been defined as "the organization or body which has the final authority to start a pension plan, make revisions to an existing plan or wind up a pension plan."[3] The Universities Academic Pension Plan could not have come into existence without the sponsorship of government. Further, the Province committed to providing the administration of the plan.

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2 The term pension deal is often used to describe the nature of the pension agreement. The most exhaustive discussion of the pension deal and its implications for plan governance was undertaken by the Ontario Task Force on the Investment of Public Sector Pension Funds. The reader is directed to the report of the task force, In Whose Interest and research reports commissioned by the task force, such as The Nature of the Pension Agreement by Mr. Don Ezra (Queen's Printer, 1987).

3 Task Force on the Investment of Public Sector Pension Funds, In Whose Interest, Queen's Printer For Ontario, 1987, p. 329.

2) The Province absorbed the existing pension funds. At that time, the predecessor University of Alberta Pension Plan was not fully funded. At the same time the Province assumed the obligation to pay all pensions under the new legislation. As a result, the assets and accrued liabilities of the predecessor plans were assumed by the Province.

3) There was no explicit requirement or commitment for employees and employers to "fully fund" the plan for either past or future service. Contributions by employees and employers were based on maintaining a 30 year positive cash flow, a common funding discipline in other Alberta provincially sponsored pension plans at that time. The contributions themselves were paid into the General Revenue Fund (GRF) and funds to pay the benefits were appropriated annually from the GRF.

The original pension deal was a provincially sponsored defined benefit plan. The pension deal was secured on the basis of the province's guarantee of future and past obligations created under the plan. The pension deal was "terminally funded" in that there was no pension fund and the contributions were set in legislation based on maintaining a positive cash flow.

The pension deal is not just what has been agreed to but also how it has been implemented, including its conventions and practices. In examining the history of the plan from 1978 to the present we see one consistent theme has been the emphasis of government in all aspects of decision making. This is evident in:

1) Plan administration. The government has always controlled the appointment of plan administrators with the administration operating initially as a separate department of government and then subsequently as a division of Treasury. Initially, the administration was accountable to the UAP Board which included employee and employer representatives. However, that line of accountability was changed in 1981 when the administration was assigned to Treasury and confirmed in 1985 with the creation of the UAPP Board.

2) Pension fund structure. In 1981, the government created a "pension fund". This fund was considered to be a "fiscal management device" of government to offset the growing liability of the collective pension obligations guaranteed by the Province. The government made an "initial deposit" of $1.1 billion for all plans. The decision to make the deposit, how much it was to be, to create a single fund rather than account for each plan separately, and to manage the fund within a division of Treasury were decisions by the government and reflected the government's interests as sponsor of the plan.

3) Funding policy. The employee and employer contribution rates were set in legislation. The combined rate was set on a cash flow basis. Since 1978, the government has elected not to change the contribution rate. The UAPP Board, however, has on a number of occasions recommended an increase in the contribution rate and those recommendations were not implemented. Further, since 1978 the government has changed the funding objective through time. With the establishment of the pension fund in 1981, the plans became "partially funded". In the Minister's proposal, the government has expressed its view that full self-funding is now appropriate.

4) Investment policy. Employees and employers have been excluded from participation in this decision. The government has maintained control of investment policy. This is consistent with the view that the UAPP was a government sponsored defined benefit plan and, through its guarantee of the benefit, the government was required to absorb the financial risk of the plan.

5) Benefits policy. The formula benefit has been unchanged through the history of the plan. However, a significant benefit, indexing, has been discretionary. The discretion to grant ad hoc adjustments has remained with the government. Employee and employer representatives through the UAPP Board have made recommendations in the past regarding formally recognizing the COLA benefit including the level of adjustments that should be granted each year.

In summary, the Province was the sponsor of the UAPP. As sponsor the Province made the commitment to absorb the existing plans as they were, to guarantee the benefit, and to make ad hoc adjustments to pensions that approximated parity with inflation. The plan was not intended to be fully funded.

GOVERNANCE

The Minister's proposal provokes a number of very fundamental questions related to governance. The funding objective of the plan will be full funding. Under the proposal employees and employers will be required to share in funding the past service deficit and to meet the full funding of future service. As a result, experience gains and losses will be translated into decreases and increases in the contribution rates. The plan will be transformed from a contributory defined benefit to an employee and employer shared risk-reward arrangement. The Province's liability will be limited to only one third of the existing past service unfunded liability. This raises a fundamental issue of governance; "If employees and employers share most of the risk, why should government retain complete control?"

Over the past 20 years the view that full funding is appropriate for public sector plans has become prevalent. The reasons supporting this view are the need to:

1) Minimize inter-generational transfers. Taxpayers should not be expected to underwrite or fund the costs of service consumed by a previous or future generation of taxpayers.

2) Provide leadership by example. The private sector pension industry has gone through successive phases of regulation. It is often argued that the government as a sponsor should follow the same rules it sets out for other plan sponsors. This has already happened in Ontario where the provincially sponsored plans must comply with the provincial pension legislation.

3) Impose a balance sheet discipline. Full funding requires that the cost and obligations of a plan be properly recognized and funded. A number of jurisdictions in Canada, such as Ontario, Quebec and New Brunswick have moved towards funding any past service deficits and full funding on a current service basis.

4) Establish security. As recognized in the Minister's proposal, a government's guarantee is no longer adequate security to a pension deal. Neither would full funding be considered adequate to secure the benefit without a shared governance of the plan.

It is the view of this Board that if a shared risk-reward arrangement is to be implemented, then the governance consequences must be recognized and addressed by the parties to the deal. For the arrangement to have "legitimacy", each party must articulate and accept its responsibilities and acknowledge the financial interests of the other parties. **The Board recommends that:**

1.1 A board of trustees (Trustees) be established consisting of employee, employer and government representatives.

1.2 The fiscal responsibility entailed in the sponsorship and administration of the plan be transferred by the Province to the Trustees.

1.3 The day-to-day administration of the plan be removed from the direct control of a government department and be operated as an independent agency accountable to the Trustees.

Employees and employers should have direct participation in all aspects of plan governance commensurate with the fiscal discipline of self-funding that they are being asked to accept. The role of government should continue as a regulator of the plan. Government's sponsorship of the plan and participation on the Board of Trustees must reduce over time as their direct financial commitment declines.

THE UNFUNDED LIABILITY

The unfunded liability of a plan is the difference between a plan's assets and accrued liabilities. According to the actuarial analysis released with the Minister's proposal, the unfunded liability of the five provincially sponsored plans directly administered by the government was about $3.4 billion. This was based on a market value for assets of $5.3 billion and accrued liabilities of $8.7 billion. The government proposal is to liquidate the unfunded liability using a payroll "surcharge" of 3% shared equally between the employees and employers in all plans and the government.

An immediate problem in dealing with the proposed plan to liquidate the unfunded liability is that the proposal deals with the plan deficits on an aggregated basis. Each plan has a different plan design and funding history. As a result, each plan has a different funded status and, therefore, the proposal would result in a very significant cross-subsidization between plans. It is difficult to evaluate any proposal unless there is an attempt to "account" for each plan separately. **The Board recommends that:**

> *2.1 A separate accounting of assets and liabilities of the UAPP be provided from the inception of the plan in 1978.*

The second question is whether employees and/or employers should share in funding the UAPP deficit. The answer would depend on the resolution of the governance issue. Historically, the plan was a provincially sponsored/guaranteed plan and therefore any past service unfunded liability remains the responsibility of the Province. **The Board recommends that:**

> *2.2 The Province take responsibility for the unfunded liability attributable to the UAPP.*

If governance were changed from 1992 on, service could accrue under a very different regime than prior to 1992. On an explicit or implicit basis, there would be two plans and potentially over time a divergence in benefit levels could occur. The Board strongly opposes the two plan scenario. To maintain a uniform benefit it may be acceptable under those circumstances for employees and employers to share some of the past service unfunded liability. **The Board recommends that:**

> *2.3 Employees and employers should be asked to share in funding the past service unfunded liability if governance is changed so that to the extent possible the same level of benefits can be maintained for past and future service.*

INDEXING

The proposal addresses a number of issues related to indexing[4] including:

1) Should indexing be formalized in the pension formula?

2) What is the appropriate formula for indexing?

Under the existing plan, adjustments to pensions are made at the discretion of the government. The proposal calls for formally recognizing indexing as a formula benefit. This eliminates some, not all, of the uncertainty associated with the benefit and provides a greater degree of security for individuals in planning their retirement. The **Board acknowledges the importance of the indexing proposal and therefore recommends that:**

3.1 Adjustment to pensions in payment be based on a formula instead of the ad hoc system being currently applied by the Cabinet when adjusting pensions.

Whether or not the formula should be 60% of Alberta CPI, is another issue. The Board is not in favour of a simple percentage of Alberta CPI formula. Relative to the assumed rate of inflation of 5%, when inflation is above the 5% individuals will lose purchasing power more rapidly than if it is below 5%. A deductible formula, such as the Alberta CPI minus 2%, provides the same degree of protection as the 60% formula if inflation is 5% as assumed by the government but in periods of high inflation, would provide proportionately more protection. There is no difference in the assumed actuarial cost of this benefit incurred by using the deductible formula. **The Board recommends that:**

3.2 The indexing formula be based on a formula reflecting the rise in the Alberta Consumer Price Index minus a percentage.

In terms of a specific formula, apart from a preference that it be based on a deductible, the Board feels it should be part of a broader discussion on cost. Any decision on indexing would have an impact on both current service and past service costs.

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4 The issue of indexing has been debated throughout the Seventies and the Eighties. For a more comprehensive technical discussion of the issue, the reader is directed to the report and research studies commissioned by the Ontario Task Force on Inflation Protection for Employment Pension Plans (Queen's Printer, 1988).

The Board recommends that:

3.3 The decision on the level of indexing be made by the plans stakeholders taking into consideration the ability of the plan to fully fund the desired level.

CURRENT SERVICE COST

The Board endorses and recommends the principle contained in the Minister's proposal that employee and employer contributions should meet the annual pension cost of the plan. The Board's support is contingent on the acceptance of a new governance arrangement. Two questions remain to be addressed:

1) How should the current service costs be calculated?

2) Are the proposed rates reasonable?

The proposal calculates the combined contribution rate using the "mid-point" between the unit credit and attained age methods. This approach builds in a funding cushion relative to the unit credit method. The rationale for such a cushion is that it will reduce the risk of a contribution rate increase when the plan is revalued in the future. The UAPP Board rejects the necessity for such a cushion. In the interest of equity to plan members, there is no need to pre-fund experience deficiencies before they actually occur. Finally, some employers and employees have expressed a willingness to accept variability in contribution rates rather than build in a cushion for stability.
The Board recommends that:

4.1 Combined employee and employer contributions be set equal to the annual cost of the pension plan with current service costs based on the unit credit method, with no additional funding cushion being applied.

The required level of contribution rates was not established by this Board. Much of the analysis on which the final proposal was based was reported in the fall of 1990 and the underlying valuations were as at March 31, 1990. By the time any proposal is actually implemented, a new valuation would be required. There is also room for debate on some assumptions. The Board would also like to see adjustments to the proposed benefit changes and additional benefits included. These may have an impact on the current service costs and their respective cost/benefit relationships should be debated. Again the issue of governance emerges. If employees and employers are required to meet the current service costs of the plan, then they should have the opportunity to review and discuss those costs within the context of plan design.
The Board recommends that:

4.2 Current service contributions be maintained at a rate sufficient to meet the current service cost of the plan, as certified by a qualified actuary.

OTHER BENEFITS

A long standing reason for the UAPP was to provide a plan for academics that would reflect the particular needs of that group. Federal tax reform and the proposals presented by the Minister impact on a number of plan features that are considered important in meeting the objectives of the pension plan, a number of which are listed below. The Board feels that these and other issues be addressed through the new governance structure.

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1) Leave without pay

2) Reciprocal transfers

3) Prior service

4) Termination benefit

5) Application of early retirement factors.

Leaves without pay:

Under the existing plan, a plan member is allowed to purchase up to two years of leave without pay. A typical academic career may require more than two years of such leave. The federal income tax regulations allow for the purchase of up to five years of leave without pay.

Reciprocal Transfers:

Reciprocal transfers allow for the transfer of service between plans where agreements are in place. While the presence of a uniform plan for academic staff in Alberta Universities facilitates the movement of individuals between institutions in Alberta, reciprocal transfer agreements are important in facilitating movement between other provincial and out-of-province institutions. Existing reciprocal agreements have been criticized because they do not allow the transfers to occur on a fully funded basis. A series of transfers into the plan could have the effect of importing unfunded liability into the plan. It has been assumed in the proposal that the actual cost to the plan has been substantial but this has not been documented. If the problem is how the transfers are priced, then rather than cancelling the agreements, an effort should be made to renegotiate reciprocal agreements on an actuarial costing basis.

Prior Service:

The plan currently allows for the purchase of service with another employer as prior service. The cost basis of purchasing service depends on the nature of the service and not its true actuarial cost. As a result, some service is available on an extremely preferential basis while other service is particularly prohibitive. This has resulted in a pattern in which heavily discounted service is purchased while more expensive service is not. The net result is that the unfunded liability position of the plan is increased.

The ability to buy prior service is a useful benefit, especially if an individual in the course of his career holds a number of non-contributory positions in a variety of institutions. The problem again is pricing. This could be corrected by basing the purchase of the service on its actuarial value.

Termination Benefit:

Under the UAPP, a plan member on termination can receive both employer and employee contributions plus 4% interest. The government proposal would replace this option with an option similar to the 50% rule found in the EPPA.[5] For a plan member terminating at a young age and with only a few years of service, it is clear that the proposed termination benefit cannot be considered to be a benefit improvement nor equivalent to the existing provision. The commuted value is very age and service sensitive and, therefore, for a young plan member half of the commuted value would be less than the employer's contributions. The impact on other plan members cannot be ascertained. In attempting to deal with this issue the Board requested and has not received additional information such as tables comparing the existing termination benefit with the proposed benefit and the cost of alternative termination benefits. The Board continues to view this as an important issue that needs to be reviewed.

Application of Early Retirement Factors:

The UAPP has not had early retirement factors in the past and they are introduced now only to comply with the 80 factor established by the Department of National Revenue. It was not clear from the actuarial analysis provided to the Board, what would be the cost impact of using 3% versus 5%. In the absence of that information, the Board felt that the discussion should be deferred.

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5 The 50% rule is based on calculating the "commuted value" of a pension and then requiring the employer to pay at least half of the commuted value. Employment Pension Plans Act, Section 29.